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REPORT BY THE

Comptroller General

OF THE UNITED STATES

Effects Of Reduced Funds For Transportation Overseas Of Military Exchange Merchandise

In fiscal year 1979 the military exchanges received over $70 million a year in appropriated fund support to ship merchandise overseas. This is a reduction of $9 million from the services' original request.

The Defense Subcommittee of the Senate Appropriations Committee asked GAO to review the impact of this reduction and of other aspects of transportation funding for exchange goods. GAO found that:

- Price increases to offset fiscal year 1979 budget reductions are not probable.
- Price increases averaging 3 percent; reduced contributions to the services' morale, welfare, and recreation programs; and increased stock of foreign merchandise are probable if all appropriated funds are eliminated.
- Space available transportation offers no real solution to prevent increases in transportation costs.

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LCD-79-224
AUGUST 14, 1979

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-169972

The Honorable John C. Stennis
Chairman, Subcommittee on Defense
Committee on Appropriations
United States Senate

SEN00302

Dear Mr. Chairman:

Your October 13, 1978, letter asked us to review and report on several matters relating to overseas transportation of exchange goods. These matters were addressed in the House conference report 95-1764, dated Oct. 11, 1978, on the fiscal year 1979 Defense appropriation bill.

Specifically we examined the effect the fiscal year 1979 budget reduction of $9 million had on the price of exchange goods, as well as the possible effect on prices if the transportation subsidy was eliminated entirely. We also inquired as to whether there was unused space available on Department of Defense contract carriers that could accommodate the movement of exchange goods without an increase in cost to the Government.

As your office requested, we did not obtain formal comments on this report, but we have discussed it with Defense officials. As agreed with your office, we are sending copies of this report to the Secretary of Defense and other interested parties.

Sincerely yours,

R F Keller

ACTING Comptroller General
of the United Stat s

COMPTROLLER GENERAL'S REPORT TO THE SUBCOMMITTEE ON DEFENSE SENATE COMMITTEE ON APPROPRIATIONS

EFFECTS OF REDUCED FUNDS FOR TRANSPORTATION OVERSEAS OF MILITARY EXCHANGE MERCHANDISE

D I G E S T

Despite a $9 million cut in the fiscal year budget request for funds to transport merchandise overseas for military exchange systems, none of the services is planning to increase prices.

While the largest of the three exchange systems--the Army and Air Force Exchange Service--projects an almost $21 million shortage of funds for overseas transportation for fiscal year 1979, it is planning to take operational and financial actions, such as reducing overseas inventories and reassigning working capital, in place of price increases. (See p. 6.)

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The Navy Resale System Office intends to use other operation and maintenance funds to the extent they are available and needed to cover their share of the budget reduction. (See p. 10.)

The exchanges generate sufficient earnings to pay all transportation costs. However, these earnings have been used for special purposes, principally as contributions to the services' morale, welfare, and recreation programs and as sources of funding for exchange facility construction projects.

If all appropriated funds for transportation were eliminated, the exchanges would have to take a combination of actions to offset the loss. The likely outcome would be

--an average price increase of 3 percent;

--reduced contributions to the services' morale, welfare, and recreation programs;

--reduced funding of exchange facility construction projects; and

--other actions designed to cut back on the need for transportation funding, such as relying on more foreign-procured products. (See ch. 3.)

Space available transportation is not a feasible option for making up losses in funding. Most cargo moves on regularly scheduled commercial ships which are not contract carriers. The Department of Defense (DOD) pays for the cargo it ships and not for unused space. What little lift is available to move cargo on a space available basis is seldom offered on routes where the exchanges could use the service. Consequently, DOD has little opportunity to recoup the $9 million reduction through space available transportation. (See ch. 4.)

Officials of the Office of Assistant Secretary of Defense (Manpower, Reserve Affairs and Logistics) do not disagree with GAO's findings but point out that any price increase would probably not be applied uniformly worldwide. Instead, they believe increases would be only overseas and then variable by overseas area. They also point out that such price increases would probably require further increases in the service members' overseas cost-of-living allowances and would cause the exchanges to stock more foreign merchandise which in turn would have an unfavorable effect on our balance of trade.

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ABBREVIATIONS

AAFES	Army and Air Force Exchange Service
DOD	Department of Defense
GAO	General Accounting Office
MAC	Military Airlift Command
MSC	Military Sealift Command
MTMC	Military Traffic Management Command

CHAPTER 1

INTRODUCTION

Military exchanges operate retail department stores, gasoline service stations, and numerous other merchandise and service outlets in the United States and abroad. They provide our military and other authorized patrons with goods and services not furnished by the Government.

The exchanges were created by the military and are governed by its regulations. Even though the Congress never specifically authorized their creation, congressional hearings and debates make it clear that the Congress is aware of and approves their existence. They have status as instrumentalities of the Federal Government.

From early one-person operations, the exchanges have grown into huge retailing activities with combined annual sales of nearly $4 billion. Today there are three major systems: the Army and Air Force Exchange Service (AAFES), the Navy Resale System Office, and the Marine Corps Exchange Service. A brief description of the organization and objectives of each system is included as appendix I. A list of the overseas areas served by the various systems is included as appendix II.

Because the exchanges operate primarily with funds generated from their own operations, they are considered nonappropriated fund activities. They do, however, receive appropriated fund support for, among other things, the overseas transportation of exchange goods. In fiscal year 1978, transportation support amounted to over $77 million as shown below.

	Transportation support (millions)
AAFES	$60.3
Navy Resale System Office	16.5
Marine Corps Exchange Service	.7
Total	$77.5

The propriety of furnishing appropriated fund support for overseas exchange transportation has been raised several times before. Much of this discussion has centered on two statutes which prohibit certain funding for the Army and Air Force exchanges. These read as follows:

> "No money appropriated for the support of the Army may be spent for post gardens or Army exchanges. However, this does not prevent Army exchanges from using public buildings or public transportation that, in the opinion of the office or officer designated by the Secretary, are not needed for other purposes." 10 U.S.C. 4779(c) [Underscoring supplied.]

> "No money appropriated for the support of the Air Force may be spent for base gardens or Air Force exchanges. However, this does not prevent Air Force exchanges from using public buildings or public transportation that, in the opinion of the Secretary, are not needed for other purposes." 10 U.S.C. 9779(c) [Underscoring supplied.]

No similar prohibition applies to Navy or Marine Corps funding.

In a 1973 report to the Congress, 1/ we stated that the Department of Defense (DOD) appeared to be exceeding its statutory authority in funding transportation because it was procuring transportation space specifically for exchange shipments without regard for whether the space was needed for other purposes. We could not say, however, that this practice was illegal. In a 1977 report to the Congress, 2/ we pointed out several instances where DOD regulations were being violated.

SCOPE OF REVIEW

The Senate Committee on Appropriations asked that we provide information on the impact of reducing appropriated fund support for the overseas transportation of exchange merchandise. Information was developed at the following headquarters of the exchange services:

1/"Should Appropriated Funds Be Used For Transportation Procured Specifically For Armed Forces Exchange Goods?" (B-169972, Aug. 6, 1973).

2/"Unauthorized And Questionable Use Of Appropriated Funds To Pay Transportation Costs Of Non-Appropriated-Fund Activities" (LCD-76-233, June 3, 1977).

--AAFES, Dallas, Texas.

--The Navy Resale System Office, Brooklyn, New York.

--The Marine Corps Exchange Service, Quantico, Virginia.

Shipping data was developed from reports of the three exchange services and the following DOD single manager transportation agencies:

--The Military Sealift Command (MSC), Washington, D.C.

--The Military Airlift Command (MAC), Scott Air Force Base, Illinois.

--The Military Traffic Management Command (MTMC), Washington, D.C.

CHAPTER 2

PRICE INCREASES UNLIKELY FOR FISCAL YEAR 1979

DESPITE BUDGET CUTS

Exchange officials do not believe they will have to increase merchandise prices to offset the $9 million fiscal year 1979 budget cut, despite the fact that current estimates of transportation funding requirements exceed the original budget estimate. The additional costs apparently will be paid out of operating revenues or other DOD funding.

BUDGET REDUCTION

The fiscal year 1979 budget cut in the services' support of overseas transportation is summarized below.

	Budget request	Approved funding	Amount of reduction	Percentage reduction
	---------(000 omitted)--------			
Army	$45,100	$42,100	$3,000	6.7
Air Force	18,393	15,393	3,000	16.3
Navy	16,272	13,272	3,000	18.4
Marine Corps	979	979	-	-
Total	$80,744	$71,744	$9,000	11.1

The Army and Air Force view the approved funding levels as defined limits on the amount of support the services can contribute to transport cargo. This means that AAFES will bear any costs above these levels.

The Navy regards the funding levels differently. It believes that any shortage in funds for the exchanges can be made up from other subaccounts in the operation and maintenance appropriations, as long as funds are still available in these accounts.

FUND SHORTAGES

Prior to fiscal year 1978, both the Army and Air Force paid transportation costs of all their overseas exchange shipments, even though there may have been instances in which the actual of these shipments exceeded projected funding levels. In these cases, there were usually adequate funds in overall operations and maintenance appropriations to cover shortages through transfers between subaccounts. The

Air Force discontinued this policy in fiscal year 1978 by establishing the approved funding level as the limitation on spending for transportation of exchange cargo. As a result, AAFES has been billed $2.5 million for transportation costs above the fiscal year 1978 Air Force ceiling of $14.2 million. The Army will also follow this policy in fiscal year 1979.

The funding cutbacks, ceiling limitations, and increases in projected transportation requirements have made it necessary for AAFES to closely monitor the status of Federal funding levels for transportation merchandise overseas. In September 1978 AAFES revised the fiscal year 1979 budget estimate sent to the Congress from $63.5 to $78.3 million. This revision was based on increases in sales overseas and higher than anticipated transportation rates--which were unknown factors and not included in the earlier estimates. This adjustment was too late for inclusion in the congressional budget submission and therefore has produced an overall projected shortage of $20.8 million as shown below:

AAFES share of cutback by the Congress	$ 6,000,000
Increase to fiscal year 1979 budget estimates	14,766,930
Total projected shortage for fiscal year 1979	$20,766,930

Overseas sales began increasing significantly in April 1978 due to devaluation of the dollar in relation to the German and Japanese currencies, as well as high inflation in other European countries. Because of less buying power on the local economy and the inflationary foreign prices, military consumers began to shift their purchasing more to the exchange system. AAFES retail sales in Europe were 22 percent higher than 1977. In the Pacific, retail sales were exceeding the original forecast by 22 percent and were 26 percent over 1977. For the AAFES fiscal year beginning in January 1979, total sales were expected to be up 8.9 percent compared with the previous year.

The net impact was a projected rise from 845,770 to 1,143,970 measurement tons of merchandise going to overseas locations by ship, or an increase of 35 percent. Air shipments were forecasted to rise by 2,085 short tons over the previous estimate, equating to a 56-percent increase.

AAFES also learned that billing rates would be raised in fiscal year 1979. The rates reflected average increases of 20 percent for MAC shipments, 14.5 percent for MSC, and 1.2 percent for port handling of merchandise.

The Navy Resale System Office does not believe it will have a shortage of funds other than the $3 million budget cut in fiscal year 1979.

EFFORTS TO OFFSET PROJECTED SHORTAGE OF FUNDS

The initial alternatives considered by AAFES to cover the $20.8 million transportation fund shortage was for the Army and Air Force to submit requests for supplemental appropriations. However, both services were unsuccessful in this option when the Office of the Secretary of Defense denied the requests. AAFES was informed of this by the Air Force in November 1978 and by the Army in January 1979.

Without the supplemental funds, AAFES has turned to other alternatives for reducing the shortage. The chart below identifies specific actions AAFES plans to take, or is considering, to offset the projected shortage of transportation funds. Because of these actions, the projected shortage of $20.8 million had been reduced to $9 million by March 1979. Methods for addressing this remaining $9 million have not been firmly established but will have to be formally determined by the Board of Directors of AAFES. For the most part, all of the possible actions are one-time-only actions and cannot be continued from 1 year to the next.

	Estimated savings
	(000 omitted)
Actions already initiated:	
Reduced shipments due to inventory adjustments.	$ 3,800
Cutbacks in beverage shipments.	2,100
Diversion of cargo from airlift to sealift.	300
Refunds to the services due to overbillings.	600
Current AAFES budget absorbed some shortage.	5,000
Total	11,800
Future considerations:	
Use of surplus cash from AAFES operations (projected for current year).	6,000
Reduced contributions to the morale, welfare, and recreation programs.	3,000
Total	9,000
Total	$20,800

Discussion of actions initiated

Actions taken by AAFES as of March 1979 may lead to potential offsets of $11.8 million to the shortage. As indicated in the above chart, $3.8 million may be saved by inventory adjustments. AAFES officials said inventory levels in some overseas locations were built up with high safety stocks earlier in the fiscal year. These safety stock levels were adjusted downward which enabled shipments to be reduced below that anticipated when the September 1978 revised forecast was developed. For example, in Giessen, Germany, inventories totaled $69 million on December 29, 1978, compared to $53.9 million on February 21, 1979.

Beer and soda shipments are being reduced to Germany and the United Kingdom which could result in $2.1 million in transportation cost avoidance. Accordingly, safety stocks, which represent 25 percent of inventory, have been reduced. Foreign beverages from Germany and the United Kingdom will likely replace American products. One of the reasons these two countries were chosen for reduced shipments was the availability of beverages overseas. For example, about 50 percent of the beer sales for Germany is currently composed of German brands. Also, all the major soda companies, such as Coca-Cola, 7-Up, and Pepsi, have plants in Germany. Cutbacks in shipments from the United States has caused concern among American producers who have no overseas plants.

About $300,000 should be saved in fiscal year 1979 by sending AAFES budget clothing goods to Germany by ship rather than on military aircraft. Overseas shipments of this apparel average about 35 tons a month and costs about $42,000 if transported by air, compared to $7,000 if sent by ship. AAFES officials said that this type merchandise is not as time sensitive as other apparel lines, and the longer shipping times should not cause a serious problem. To compensate for this, the amount of merchandise to be procured will be increased somewhat to provide exchange stores a larger overseas inventory.

As another effort to recoup funds, AAFES will begin auditing all transportation billings made by MSC and MAC. Based on a test audit of 1 month's charges, AAFES feels MSC and MAC improperly billed the services for about $600,000 over a 2-year period.

Finally, when AAFES had prepared the budget for its current fiscal year (January 26, 1979 - January 25, 1980), it had included a $5 million provision to cover the anticipated shortfall in transportation funds. This was formulated in October 1978 on the assumption that supplemental funding would make up the remaining $15.8 million shortage. Supplemental funding, however, was not approved to cover the shortage.

AAFES officials predict that transportation funds will be fully depleted in August 1979. Evidence suggests that at that point, the Board of Directors will be required to render a policy decision on further actions to absorb the remaining shortages. Two primary considerations identified thus far are to (1) apply a projected cash surplus of $6 million to the shortage and (2) reduce contributions to the morale, welfare, and recreation funds.

Other options considered

In November 1978 AAFES also identified additional options which could be adopted to offset the transportation fund shortage. These included:

--Raising merchandise prices overseas.

--Contracting directly with ocean carriers for overseas shipments at rates below MSC's billing rates.

--Increasing procurement of foreign merchandise.

--Using space available transportation.

For various reasons, however, these alternatives have been ruled out, at least for this year. With regard to price increases, AAFES is intent on avoiding any such actions. It feels that any increase would be viewed as an erosion of service benefits. Transportation has long been funded out of appropriations and any change would be unwelcomed. Further, as discussed below, the assumption of transportation costs by the exchanges' patrons may place the patrons in the position of subsidizing the U.S. merchant marine. As to the second option, AAFES believes it could occasionally procure shipping services more cheaply by contracting directly with the carriers MSC uses or with foreign-flag carriers. However, DOD currently requires AAFES to use MSC. Accordingly, this option is unavailable at this time. But, if AAFES is paying higher transportation costs because it is required to use MSC, and it is forced to pass these costs on to its patrons, the patrons would, in effect, be subsidizing U.S.-flag lines. This is because MSC is required by law to use U.S.-flag lines even where foreign shipping might be cheaper.

Major foreign procurements are currently planned in only one area--beverages. In the future, with the availability of many other acceptable foreign products and the possibility of less transportation funding, AAFES may consider stocking more foreign products.

Finally, space available transportation is of little use to offset the cutback in transportation funding. Actually, space available transportation is extremely limited and what little there is cannot be used effectively by the exchanges.

Specific Navy options

Percentagewise, the Navy's reduction in transportation funding for exchange shipments was the greatest of the three services. Yet overall, its shortfall of funds is expected to be much less than that of the Army and Air Force, and the Navy does not believe that its exchanges will have to increase merchandise prices.

The Navy anticipates that the actual shortfall will be more than the cut in funding--$3 million. It believes that the original budget may cover the shortfall because of decreased shipping requirements. However, if it does not, the Navy intends to fund the shortfall by switching funds between accounts within the total operation and maintenance transportation budget. The Navy believes that the exchange funding ceiling can be exceeded as long as there are funds available in other transportation accounts of the operation and maintenance budget.

CONCLUSION

The exchanges do not plan price increases as a result of the $9 million reduction in the services' fiscal year 1979 support for transportation. They plan to pay for funding shortfalls through operational and financial management changes, such as reducing inventories, reassigning working capital, or through use of other operation and maintenance funds. These changes are possible for the most part only this year and cannot be continued from 1 year to the next.

CHAPTER 3

ELIMINATION OF TRANSPORTATION SUPPORT WITHOUT

PRICE INCREASES WOULD HAVE REPERCUSSIONS IN OTHER AREAS

Should the Congress eliminate its funding of overseas transportation of military exchange merchandise entirely, the exchanges would have essentially three options to consider to offset the loss: absorb the cost, raise prices, or reduce the need for and cost of transportation to ship merchandise overseas.

At this stage, neither the exchanges nor DOD is sure which action or actions would be undertaken if the Congress eliminated the transportation support. Evidence suggests that a combination of actions would have to be taken with average merchandise selling prices rising by about 3 percent. Also, the exchanges would provide much less funding for the services' morale, welfare, and recreation programs and exchange construction projects. Finally, more foreign merchandise would appear in the overseas exchanges.

OPTION TO ABSORB COSTS OF TRANSPORTATION

It is DOD's policy that merchandise and services sold through military exchanges be priced in a substantially uniform manner at the lowest practicable level consistent with the primary mission of the exchanges of providing authorized patrons with articles and services necessary for their health, comfort, and convenience. The creation of a source of funding for welfare and recreational programs is to be considered a secondary mission when establishing selling prices.

The exchanges do generate profits every year and the amount has exceeded the amount of funds DOD has provided for transportation support. The comparative amounts for the exchanges' fiscal year 1978 are summarized on the following page.

	Earnings (note a)	Transportation support (note b)	Excess
	------------	(millions)	------------
AAFES	$ 82.1	$60.3	$21.8
Navy Resale System Office	41.8	16.5	25.3
Marine Corps Exchange Service	14.0	.7	13.3
Total	$137.9	$77.5	$60.4

a/Exchanges' fiscal years end in January. Fiscal year 1978 ended January 25 for AAFES and January 22 for the Navy and Marine Corps systems.

b/Government's fiscal year ends on September 30.

If the exchanges use their earnings to pay for transportation, there would be much less money to support the morale, welfare, and recreation programs and to pay for their own construction projects. In fiscal year 1978 the exchanges contributed over $110 million for morale, welfare, and recreation and used over $75 million of their own working capital to provide for facilities to conduct their operations.

The actual sources of these funds and how they were used are shown in the following chart on the exchanges' working capital for fiscal year 1978.

Source and Uses of Working Capital for Fiscal Year 1978

	Exchange system			
	Army and Air Force	Navy	Marine Corps	All
	(millions)			
Sources of working capital:				
Net earnings	$ 82.1	$41.8	$14.0	$137.9
Depreciation	46.6	13.5	2.5	62.6
Other sources	10.0	2.0	.5	12.5
Total	$138.7	$57.3	$17.0	$213.0
Uses of working capital:				
Dividends or contributions to the morale, welfare, and recreation programs	$ 63.8	$40.0	$ 8.0	$111.8
Additions to property and equipment	54.0	12.9	7.3	74.2
Other uses	5.2	4.7	.1	10.0
Total	$123.0	$57.6	$15.4	$196.0
Increase (decrease) in working capital	$15.7	-$0.3	$1.6	$17.0
Accumulated working capital at year end	$312.0	$118.3	$42.3	$472.6

As shown, in fiscal year 1978 the exchanges gave over $110 million to the services and local commands for morale, welfare, and recreation. As pointed out in a prior report ("Appropriated Fund Support For Nonappropriated Fund and Related Activities In the Department of Defense," FPCD-77-58, Aug. 31, 1977), congressional committees have since 1949 stated that morale, welfare, and recreation ought to be funded primarily with appropriated funds, but at the same time considered it impractical to do so. In fact, DOD has never requested full funding support for the programs. As a result, the exchanges generate revenue to support morale, welfare, and recreation programs.

In our 1977 report, we pointed out the feasibility of the Government supporting certain aspects of morale, welfare, and recreation directly with appropriated funds. This would relieve some of the burden on the exchanges to generate earnings. We are presently reviewing the mission of the exchanges, particularly as related to need to generate earnings for support of morale, welfare, and recreation programs.

The exchanges consider cutbacks in morale, welfare, and recreation dividends a feasible and likely occurrence in conjunction with foreign procurement and selective pricing increases, as will be shown later, to compensate for the elimination of transportation funds. To date, none of the exchanges has taken action on the matter, but reductions would probably take place if transportation funds were cut.

The exchanges have also used approximately $75 million a year for capital expenditures, mostly to replace substandard buildings and renovate existing structures. This has been necessitated by the lack of appropriated funds being provided by DOD and the Congress. AAFES, for example, has used funds generated by exchange earnings for new construction and renovation of facilities since 1963. Over the past 2 years, AAFES has provided a total of $119 million for this purpose.

Reduction of appropriated fund support and the limitation of nonappropriated funding for capital expenditures would, the exchanges feel, result in a general deterioration of exchange physical plants. Exchange officials point out that capital expenditures are needed to keep the exchanges competitive and that funds for these expenditures are derived solely from exchange profits. Capital expenditures are usually evaluated based upon expected return on investment. New and renovated facilities, the exchanges feel, result in improved morale, increased sales, more efficient operations, and improved ability to offset price increases and generate dividends. In many cases, they believe, new equipment and facilities are labor saving, resulting in expense reductions far greater than the initial capital investment and any significant curtailment of construction due to loss of transportation funds would decrease earnings potential. To date, no plans have been developed to change construction expenditures due to fund curtailments in transportation support.

There is little question the exchanges are an important means by which appropriated funding is avoided for morale, welfare, and recreation and for construction projects. The exchanges cannot provide these funds and pay the transportation cost of shipping their merchandise overseas from present earnings levels. But the question of whether the exchanges should have to maintain these earnings levels is left unanswered.

OPTION TO RAISE MERCHANDISE SELLING PRICES

There is no easy answer to the question of how much merchandise prices would have to be raised to cover the added costs of transportation. It depends on how the added costs are distributed and what effect price increases would have on sales. Any price increase over 3 percent would probably have a negative effect--decreased sales more than offsetting increased revenue from raised prices--but increases of 3 percent or less would not generate sufficient revenues to cover the added costs of transportation.

The added cost of transportation can be viewed in terms of percentage of sales. The fiscal year 1978 transportation support would have represented an added cost of 2.3, 1.5, and 0.3 percent of worldwide sales for AAFES, Navy Exchange, and Marine Corps Exchange Service, respectively. If only retail sales were considered, transportation would have represented an added cost of 3, 2.2, and 0.4 percent for the three exchanges, respectively. If only overseas retail sales were considered, the added cost would have been 8.3, 6.9, and 3 percent, respectively.

These figures are for comparisions only and should not be viewed as percentages by which prices could be increased across-the-board to cover the added cost of transportation. Such an assumption would fly in the face of consumer resistance to price increases and availability of substitutes for products sold in the exchanges. In the United States, exchanges do not have a "captive" market because competition from discount stores makes comparative buying easier than in overseas locations. Sixty percent of AAFES retail sales, for example, are realized in the United States and competition is strong in merchandise such as apparel, health and beauty aides, and tobacco products.

Overseas commissaries, which are appropriated fund activities, compete with the exchanges in several areas, such as health and beauty aides and sodas. The Army and Air Force commissaries also compete with the exchanges on cigarettes, which were a major sales item in the exchanges prior to their availability in the commissaries. Since the commissaries are not required to make a profit, they can sell cigarettes at a lower cost than the exchanges. AAFES' segment of the cigarette market is now only 38 percent and further price increases will mean a further dropoff in sales and profits for the exchanges.

AAFES' analysis has shown that price increases above 3 percent on worldwide retail sales would not be profitable. At a 4-percent increase, for instance, there is no net return in profit and at 3 percent the return is $23.4 million (based on projected fiscal year 1979 worldwide retail sales).

This is less than what the transportation costs would run. The chart depicts various outcomes and is based on the assumption that AAFES would lose business to the commissaries overseas in health and beauty aides, cigarettes, and soda. As discussed above, sales in the United States would also decrease.

Price increase	Increase in selling prices	Loss in sales	Net increase or decrease to earnings
(percent)	-----------------(millions)	-----------------	-----------------
1	$ 23.4	$ 11.7	$11.7
2	46.8	23.4	23.4
3	70.2	46.8	23.4
4	93.6	93.6	-
5	117.0	187.2	-70.2

Exchange officials believe the more feasible approach to pricing is to do so only on merchandise shipped overseas. This formula would be applied based on the product's ability to withstand price increases without negatively affecting earnings through customer shifts to other sources. As a result, careful attention will be given to overseas competition in the various sales categories. Selective pricing may dictate that prices on certain merchandise not be increased at all on those goods which could be purchased more competitively overseas.

Appendix III contains a list of popular products sold overseas in the exchanges and shows the percent the selling price would have to increase to cover transportation. As can be seen with these 37 listed products, transportation would represent from 0.3 to 240.9 percent of the selling prices.

Exchange location	Mean percent increase	Range of percent increase
Germany	6.9	0.3 - 28.4
Hawaii	7.8	.3 - 33.2
Alaska	9.1	.4 - 38.8
Korea	9.7	.4 - 40.0
Greenland	45.3	2.0 - 240.9

To Germany, for example, the cost of transportation would represent 3 percent or less on over half the items listed. These would include such items as razor blades, toothpaste, cigarettes, men's shirts, and women's hosiery. The cost could be well over 10 percent on other items, such as on motor oil, beer and soda, and disposable diapers. The costs to Hawaii, Alaska, Korea, and Greenland would be progressively higher.

It should be considered, too, that price increases could affect other areas. These include the probability that the service members' cost-of-living allowance would have to be increased since the difference in prices between the exchanges and the local economy serve as an important element in the allowance calculation. However, a 3-percent increase in prices, for example, would not necessarily mean an automatic 3-percent increase in the allowance. It is very difficult to calculate just what the increase would be.

If price increases are made, overseas customers could shift their soda, cigarette, and health and beauty aid purchases to the commissaries and thereby cause an increase on the amount of appropriated funds that would be needed to ship the goods overseas, since commissary merchandise shipments are paid from appropriated funds.

Purchases made on the local overseas' economies would have gold flow implications. They would mean a negative balance of payment situation and any shift of purchases from the exchanges have the potential to reduce the exchanges' earnings.

In summary it is very difficult to state that a single percentage price increase could accommodate the added cost which would be needed to fund overseas transportation. It appears an average 3-percent increase on worldwide retail sales would generate the optimum additional earnings, but not enough to fully cover the added cost of transportation.

OPTION TO TAKE OPERATIONAL ACTIONS WHICH WOULD REDUCE THE NEED FOR TRANSPORTATION FUNDS

The exchanges could take and, indeed have considered, a number of operations to reduce the overocean transportation costs. These considerations include

--reducing the volumes and ranges of merchandise stocked overseas,

--increasing the procurement of foreign-made merchandise,

--negotiating procurement contracts which include the cost of transportation in them,

--contracting for lower cost transportation outside the DOD system, and

--diverting air shipments to less costly surface transportation.

Reducing availability of merchandise overseas

The exchanges do not plan arbitrary reduction in overseas merchandise. However, some products might disappear if transportation support were eliminated. AAFES, for example, will consider eliminating beverage sales to the military clubs overseas. At present, merchandise is sold to those establishments at cost plus an administrative fee. At present this fee is 15 percent for beverages in Germany and 7.67 percent in Korea compared to the normal exchange markup of 35 percent. Annual overseas sales of this type in Europe and Korea amount to about $13 million. Estimated transportation costs to support these sales is about $2.6 million. AAFES management believes that if these transportation costs are added to the selling prices, clubs would no longer purchase from exchanges but switch to local sources or buy directly from U.S. sources.

As mentioned in the previous chapter, AAFES is making some inventory adjustments, such as reducing the shipment of beer and soda overseas. However, this is a one-time-only reduction and there are no plans to keep cutting down on inventories in successive years.

Increasing the procurement of foreign-made merchandise

Exchange officials indicated they fully support the concept of supplying exchanges with merchandise manufactured or distributed by American companies. However, loss of transportation funds will significantly alter this attitude. In conjunction with selectively raising prices and merchandise, the exchanges will shift procurement to overseas markets on those products competitive with American-made lines. Already efforts are being intensified to identify additional foreign-made supply sources in Europe and the Pacific.

The table below shows that, during fiscal year 1978, 28 percent of the merchandise procured for AAFES in Europe and the Far East exchanges was from foreign suppliers.

Department	U.S. procured	Foreign procured
	(millions)	
Automotive	$ 11.1	$ 14.1
Tobacco and smoking	48.2	1.5
Food	156.2	4.3
Toiletries, cosmetics, and drugs	63.3	3.7
Military clothing	5.4	0.0
Watches and jewelry	22.0	14.8
Stationery and cards	20.3	4.8
Clothing, non-military	142.0	19.8
Household	94.2	27.5
Sundries	102.8	169.8
Total (note a)	$665.6	$260.3
Percent	72	28

a/Totals may not add due to rounding.

Exchange officials explained that development of new foreign supply sources would not be an arbitrary process. Extensive research is required with careful consideration given to product acceptability and comparability to U.S.

brands. There are many American products which the servicemember readily identifies with and for which there are limited opportunities for foreign substitutes. In hardlines, for instance, the overseas customer relies on American products, such as appliances and auto parts, because few foreign manufacturers are producing merchandise of comparable price, quality, and availability. Conversely, there are some overseas manufacturers in luggage and apparel, for instance, which export to American companies that, in turn, sell the same merchandise to the exchanges for overseas sale. These products are of proven acceptability and may be purchased at a lower cost overseas if transportation funds were eliminated.

In seeking foreign sources, of prime concern would be the quality of the product and customer acceptability in the exchanges. Products would gradually be phased into store operations with close attention given to achieving a proper balance of foreign and American merchandise. In apparel, virtually 100 percent of all merchandise could be purchased overseas but this would be at the expense of customer preference. Therefore, tradeoffs between merchandise costs overseas and potential loss of the customer is imperative.

Increased foreign procurement could also affect unfavorably on American business since the exchanges represent substantial customers. This could mean loss of revenues and possibly loss of jobs. The impact could be permanent in that some overseas patrons may accept and prefer foreign-made goods after they have returned from overseas assignment. Beer, which is one of the major items shipped overseas, is particularly susceptible to this phenomenon.

Negotiating procurement contracts to include transportation

Another action which could possibly reduce transportation costs would be for the exchanges to buy merchandise on an FOB (free on board) destination basis; i.e., delivered at the manufacturer's expense. The savings would result where the manufacturer is able to ship at less cost than DOD or the exchanges.

AAFES, for instance, has asked nine beverage companies to make proposals on an FOB destination basis. While the responses have been unacceptable to date, there is the possibility that savings could be produced.

Contracting for lower cost transportation outside the DOD system

Although DOD currently prohibits the exchanges from contracting for steamship and port handling services outside the DOD transportation system, there is a good possibility that they could save funds in this area if allowed to do so. As noted in the previous chapter, the exchanges' ocean transportation is provided by or through MSC, using either its own and chartered fleet of ships or buying services from commercial carriers. For this service, MSC charges DOD customers based on rates which are designed to cover MSC's overall costs and not necessarily the individual shipment costs or charges paid to the commercial carriers. Consequently DOD shippers find it would be cheaper on some shipments to bypass the MSC system and deal directly with the commercial carriers. Examples of this disparity are shown below.

Comparison of Commercial Charges with MSC's Charges for Shipping a Single Container of Cargo of Selected Sizes

Container destination	Commercial charges		MSC charges		Difference	
	35 ft.	40 ft.	35 ft.	40 ft.	35 ft.	40 ft.
Germany	$2,028	$2,322	$1,988	$2,275	$ -40	$ -47
Korea	1,608	1,840	2,879	3,295	1,271	1,455
Okinawa	2,005	2,295	3,376	3,866	1,371	1,571
Japan	1,706	1,952	2,530	2,896	824	944

Generally, shipments in the Pacific would be cheaper outside the DOD system. DOD officials, however, have refused to allow the exchanges to deal directly with the carriers; they must go through MSC. To the exchanges, as long as DOD is supporting them with transportation, the difference in charges is inconsequential. However, if they are required to fund their own transportation, they would like to have all the options available to them to minimize their costs. The Office of the Secretary of Defense has asked various transportation operating agencies to reevaluate their billing systems to bring the charges to the services more in line with the services provided.

Diverting air shipments to less costly surface transportation

The exchanges ship some merchandise overseas by air. For example, about 2 percent of AAFES' overseas shipments are by air, usually because the cargo must adhere to strict time scheduling to meet customer needs for items such as fashion clothing and phonograph records. Also, it is used where surface shipping is unavailable to isolated areas such as Greenland.

About half of the air cargo goes by MAC. Since MAC's air charges are considerably higher than surface charges, the diverting of cargo, where acceptable, to surface transportation could save funds. The potential savings are small. however, perhaps only several hundred thousand dollars a year.

CONCLUSION

If all appropriated fund support for transportation were eliminated, the exchanges would have to take a combination of actions to offset the loss. Although the exchanges earn more than the added cost of transportation would be, these earnings are committed for special purposes, principally as contributions to the services' morale, welfare, and recreation funds and as sources of funding for exchange construction projects.

Price increases alone could not generate sufficient earnings to maintain existing earnings' levels and pay for transportation. Increases up to 3 percent would provide additional earnings but not enough to pay for the added transportation costs.

The likely outcome would be an average price increase of 3 percent, along with various operational actions to cut back on the need for transportation funding--such as relying on more foreign-procured products--and a reduced level of contributions to the morale, welfare, and recreation programs of the services and for funding of exchange facility construction projects.

In the past we have pointed out that it is feasible for the Government to support certain aspects of morale, welfare, and recreation directly with appropriated funds. This would relieve the exchanges' need to generate earnings for this purpose. We are presently reviewing this area in another study.

CHAPTER 4

SPACE AVAILABLE TRANSPORTATION--GENERALLY

NOT AVAILABLE OR SUITABLE FOR EXCHANGE SHIPMENTS

The fiscal year 1979 reduction was applied equally to the Army, Navy, and Air Force transportation programs. The conference committee on DOD's 1979 appropriations directed the services to attempt to recoup these funds to the extent possible by using space available transportation. Under today's shipping practices, this is not a viable option.

Many years ago, DOD shipped much of its supplies overseas on ships owned by or under charter to the Army and Navy or in space chartered from commercial carriers. If the military services did not use all the cargo space for a particular voyage or for what they had charter, the unused space was offered free to the exchanges as "space available" because the Government was already obligated to pay for the space.

More recently, DOD has been shipping its cargo on regularly scheduled commercial ships under terms of shipping agreements. It buys transportation on the basis of the tonnage of cargo actually tendered to the commerical shipping companies. Since DOD can meet its peacetime general cargo requirements in this manner, there is little need for Government-owned ships or for ships under charter, except to those areas where regularly scheduled commercial service is infrequent or nonexistent. Consequently, there is almost no transportation on which space available exchange cargo could move.

USEFULNESS OF SPACE AVAILABLE TRANSPORTATION

Because space available transportation occurs only on a limited type of transportation resource--Government and chartered ships and aircraft--the opportunities for the exchange systems to use it are relatively few. Moreover, these resources are generally available on only a few routes and provide very limited service. For the exchanges to have to rely on uncertain sailing schedules for a significant portion of their shipments, their ability to maintain reliable stockages of merchandise overseas, or in effect, to carry out their primary mission, would be restricted.

DOD ships cargo overseas by surface in essentially three different ways--on its own ships, on chartered ships, and on regularly scheduled commercial ships. For example, in fiscal year 1978, DOD shipped the overwhelming majority (86.7 percent) of its general and refrigerated cargo on the regularly scheduled commercial ships.

Ships Used for DOD Cargo

Ships	Measurement tons (note a)	Percent of total
Government owned	119,986	2.8
Chartered	460,126	10.5
Regularly scheduled commercial	3,795,259	86.7
Total	4,375,371	

a/One measurement ton equals 40 cubic feet.

An even higher percentage (97.6 percent) of exchange cargo has been moved on regularly scheduled commercial ships.

Ships Used for Exchange Cargo

Ships	Measurement (tons)	Percent of total
Government owned	3,719	0.3
Chartered	26,030	2.1
Regularly scheduled commercial	1,209,788	97.6
Total	1,239,537	

On the basis of costs borne by the services for exchange shipments in fiscal year 1978, the $9 million budget cut represents a loss of funding for approximately 150,000 measurable tons of cargo. 1/ Finding space for that amount of cargo on Government owned or chartered ships would not be easy. This tonnage is five times more than the total amount of cargo the exchanges shipped on Government owned or chartered ships in 1978.

1/The services' average ocean cost for exchange shipments was $50.80 a measurement ton and $8.64 for port handling and shipment documentation.

This does not mean that all of the Government owned and chartered ships have no leftover or underused space, because they do. However, these ships are seldom used on the routes where the exchanges would need the service. MSC generally uses its own ships to service those routes where commercial service is infrequent or nonexistent. Therefore, it is not a matter of the exchanges simply shifting their cargo from commercial ships to Government ships, since the Government ships offer no alternative to the commercial ships.

Exchange cargo is a type of cargo which is highly pilferable, subject to damage, and time sensitive. Because of this, it generally requires "containerization." Containerization of cargo means prepackaging cargo into rigid steel boxes, most often of dimensions approximately 20x8x8 feet or 40x8x8 feet, capable of being carried as a single unit over highway, rail, or ocean transport. It generally gives cargo more security, less susceptibility to damage, and faster delivery time. Roughly, 90 percent of exchange cargo is containerized. Yet almost none of DOD's owned or chartered ships is equipped to handle containerized cargo.

Ultimately, the usefulness of any transportation must be judged on its reliability. Space available transportation is inherently unreliable. Government and chartered ships are generally not run on timetables which would meet the exchanges' delivery time frames. Even if they were, there would be no guarantee that any space available cargo would be loaded onto any such ship or that it might not be off loaded for higher priority cargo enroute. Late arriving cargo would mean out-of-stock problems overseas and loss of sales, resulting in lower profits. If cargo arrived too soon, it would mean overstocking and added storage costs with corresponding loss of profits.

The problems with sealift are also applicable to airlift. Even less capability exists in airlift and there would still be major problems of reliability of delivery schedules using space available transportation.

CONCLUSION

Under the present method of procurement for transportation services, DOD has relatively little opportunity to move exchange cargo on a space available basis.

ORGANIZATION AND OBJECTIVES OF THE EXCHANGE SYSTEMS

ARMY AND AIR FORCE EXCHANGE SERVICE

AAFES is the largest of the three exchange systems, accounting for about 65 percent of the combined sales volume of all exchanges. AAFES has an annual sales volume of over $2-1/2 billion, and is one of the largest retail organizations in the United States.

With headquarters in Dallas, Texas, the system operates several thousand retail stores within the continental United States and around the world, including its offshore exchange system and three overseas exchange systems--AAFES-Europe, AAFES-Pacific, and the Alaskan Area Exchange. It is governed by the Secretaries of the Army and Air Force and is administered by the commander of the exchange service, who acts for a 13-member board of directors.

The stated objectives of AAFES are to (1) provide to its patrons--for necessity and convenience--merchandise and services not furnished through Federal appropriations, (2) sell the merchandise and service at uniformly low prices, and (3) generate from the sales reasonable earnings to supplement appropriated funds for the support of Army and Air Force welfare and recreation programs.

THE NAVY RESALE SYSTEM OFFICE

The Navy Resale System Office operates the Navy and MSC exchanges, and the Navy commissary stores and ships stores afloat. Its approximately 150 main and supporting Navy exchanges are administered at the end of a chain of command extending from the Secretary of the Navy, the Chief of Naval Operations, the Chief of Naval Material, and the Naval Supply Systems Command. A committee of business and educational advisors make recommendations on policies, operations, and organization.

The objectives of the Navy exchanges are to (1) provide patrons with convenient and reliable sources of articles and services at the lowest practicable sales prices, (2) provide, through profits, a source of funds to be used for the welfare and recreation of naval personnel, and (3) promote the morale of the command in which the exchange is established.

THE MARINE CORPS EXCHANGE SERVICE

The Marine Corps Exchange Service is an administrative division under control of the Marine Corps Deputy Chief of Staff for Installations and Logistics. It provides policy and technical direction to 17 Marine Corps exchanges in the continental United States, Hawaii, the Canal Zone, Japan, and Cuba.

The mission of the Marine Corps exchanges is to (1) provide, at reasonable prices, military personnel and dependents with articles and service necessary for their health, comfort, and convenience and (2) provide, through reasonable profits, recreation funds for its patrons.

OVERSEAS LOCATIONS OF THE EXCHANGES

Location	AAFES	Navy Resale System Office	Marine Corps Exchange Service
Offshore area:			
Alaska	X	X	
Hawaii	X	X	X
Guam	X	X	
Puerto Rico	X	X	
Canal Zone	X		X
Canada/Atlantic/ Caribbean area:			
Newfoundland	X	X	
Greenland	X		
Iceland		X	
Azores	X		
Antigua		X	
Bahamas		X	
Bermuda		X	
Cuba		X	X
Turks and Caicos Islands		X	
European area:			
Belgium	X		
Crete	X		
Germany	X		
Greece	X		
Italy	X	X	
Netherlands	X		
Norway	X		
Saudi Arabia	X		
Spain	X	X	
Turkey	X		
United Kingdom	X	X	
Pacific area:			
Australia		X	
Japan	X	X	X
Korea	X		
New Zealand		X	
Okinawa	X		
Philippine Islands	X	X	
Johnston Islands	X		
Eniwetok Atoll	X		

PERCENTAGE PRICE INCREASE NEEDED TO COVER

TRANSPORTATION COST

Item	Destination Germany	Hawaii	Alaska	Korea	Greenland
Automotive:					
Motor oil	12.9	15.3	17.6	18.8	110.6
Household:					
Cookware set	1.8	2.1	2.4	2.5	15.5
Garden hose	5.7	6.7	7.8	8.0	36.9
Ice chest	15.6	18.2	21.2	21.8	74.0
Toaster	4.1	4.8	5.6	5.7	19.4
Wastebasket	28.4	33.2	38.8	40.0	135.2
Sundries:					
Laundry detergent	13.8	16.9	20.0	20.0	101.5
Oven cleaner	5.5	6.2	6.9	7.6	42.1
Food and drink:					
Beer	24.8	23.3	28.1	34.9	218.0
Candy	4.0	4.0	4.0	4.0	28.0
Soda	27.4	25.7	31.0	38.5	240.9
Toiletries and bath accessories:					
Bath towels	2.5	2.9	3.5	3.5	12.2
Disposable diapers	15.3	17.9	20.4	21.3	71.9
Kleenex	14.3	17.5	20.6	20.6	71.4
Mouthwash	18.8	21.7	24.6	26.1	163.8
Razor blades	.5	.5	.9	.9	2.8
Shampoo	2.1	3.2	3.2	3.2	11.6
Shaving cream	4.0	4.8	5.6	5.6	36.7
Toothpaste	2.6	2.6	3.5	3.5	20.9
Tobacco:					
Cigarettes	2.2	1.8	2.1	2.5	8.6
Stationery:					
Envelopes	10.0	11.7	13.3	13.3	50.0
Specialty items:					
Electric razor	.3	.3	.4	.4	2.0
Luggage	5.0	5.9	6.9	7.1	23.9
Projection screen	2.7	3.2	3.7	3.8	24.3
Stereo speakers	3.2	3.8	4.4	4.6	15.4
Slide projectors	1.6	1.8	2.1	2.2	7.5
Television	3.9	4.5	5.3	5.4	18.5
Non-military clothing:					
Boys' jeans	3.3	4.0	4.5	4.7	16.0
Girls' shoes	1.8	2.1	2.4	2.5	8.4
Men's jeans	2.7	3.1	3.6	3.7	12.5
Men's shirts	.7	.8	1.0	1.0	3.4
Men's underwear	3.4	4.0	4.6	4.9	16.0
Women's hosiery	.7	.7	1.3	1.3	5.9
Women's slips	.8	.8	1.0	1.0	3.9
Military clothing:					
Fatigue jackets	3.5	4.0	4.8	4.9	16.4
Fatigue pants	4.3	5.1	5.9	6.1	20.6
Military jump boots	1.8	2.2	2.5	2.6	8.8
Average	6.9	7.8	9.1	9.7	45.3

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